RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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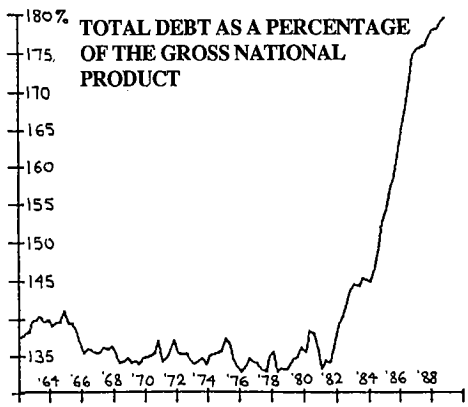
Feb. 8, 1989 **LETTER 1010**

Jan. 27 DJIA 2322.86; PTI 2886; A-D Ratio -10.12
Feb. 3 DJIA 2331.25; PTI 2903; A-D Ratio -9.63
Current Dow Yield: 3.45%; Dow P/E: 12.9
Dow Book Value: 1009; Dow 200-day MA: 2105
DowPow: 913
Percentage of undervalued blue-chips: 19%

STOCK MARKET: Based on yields, price pattern, percentage of undervalued stocks, and several other considerations, I am increasingly of the opinion that the stock market since early-1987 (yes, including the crash) is in the process of forming a massive multi-year top. The top (or distribution area) began in January 1987, when the D-J Utility Average topped out at 227.83. It continued through August of 1987 when the D-J Industrials and Transports topped out. Then came the October 19 crash.

Following the crash we've witnessed a steady recovery in the market, a recovery fueled by a continuation of the longest economic expansion in history, lower tax rates, a torrential influx of foreign money, numerous corporate takeovers, a strong bond market, very heavy retail buying and last, but certainly not least, a very accomodative policy (despite what you may hear) on the part of the Fed.

On top of all this we have experienced an absolutely incredible borrowing binge, a debt explosion that has produced what economist Ed Hyman of *CJ Lawrence* calls "the most dangerously leveraged situation on record." This chart (courtesy of *CJ Lawrence*) underscores Hyman's warning. Here we see total US debt (going back to 1962) as a percentage of GNP. It's a chart worth studying, because it gives you some idea of what could happen when the market and economy finally turn down.



THE PICTURE: Over the last few weeks we've seen the Dow surge well above the 2230 halfway level of the August-October bear market decline (i.e., the decline from the August 2722.42 high to the October crash low of 1738.74). In other words, the Industrial Average has now recouped better than 50% of its 1987 losses. On the face of it, this is a positive accomplishment.

The action of the Dow in rising above 2230 is bullish, but it does not change my opinion that this is a bear market rally (i.e., an advance that has come within the context of a primary bear market).

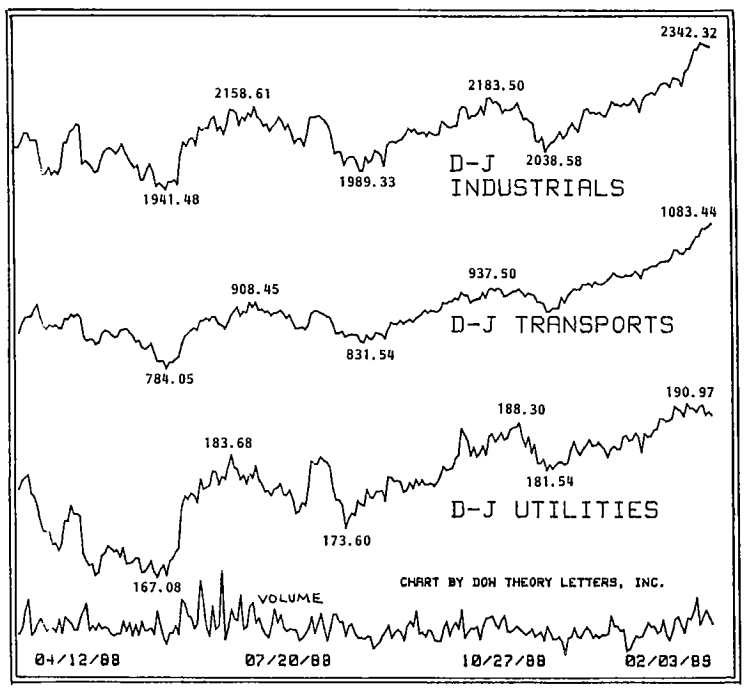
As I've said so many times before, the bear (being cruel and heartless) has one desire: he wants to bring the market down -- while taking as many investors and traders with him as possible. Following the 1987 crash, Wall Street and the public were traumatized. And the bear wondered how he could lure more investors and more money back to the market.

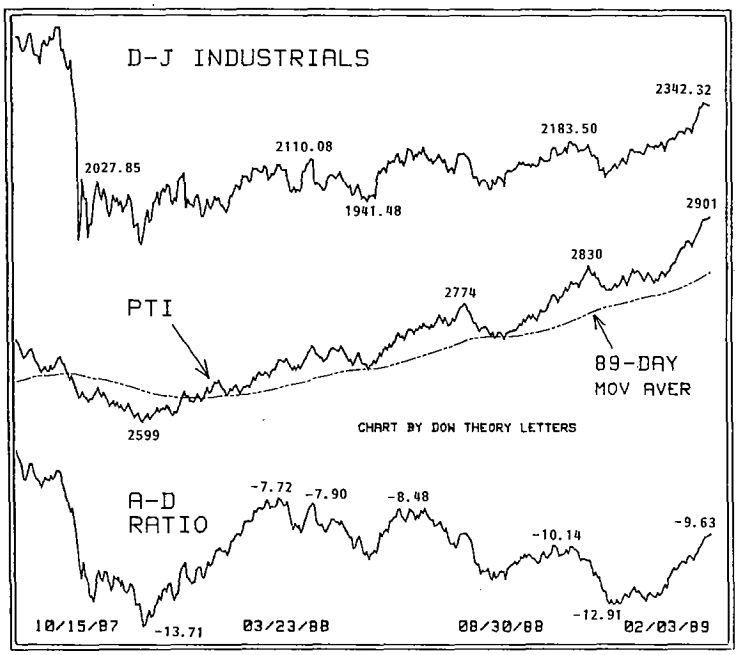
There is only one way -- an advance that looks more like a bull market than the real thing. That, in my opinion, is what we've been seeing. This advance is the vehicle by which the bear means to bring the players back to the fold. And the higher the Averages climb, the more players will return.

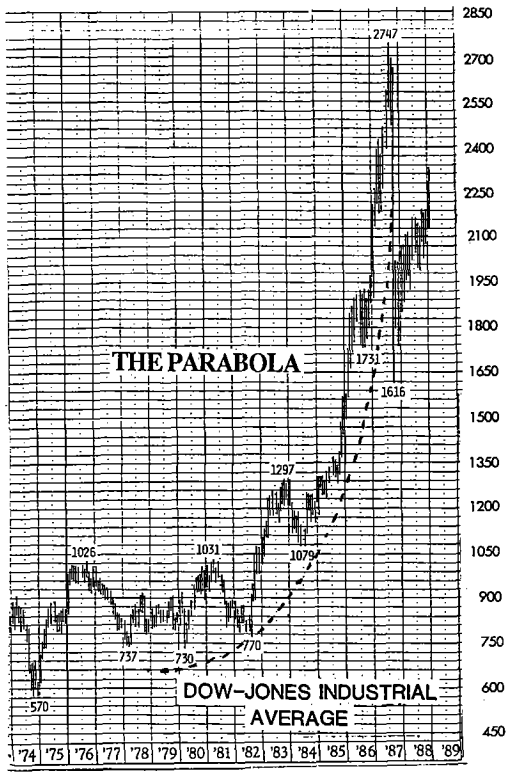
You can see and hear the sentiment changing. Today the question I'm most often asked is, "Russell, do you still think it's a bear market?" And my answer is, "Yes, I do." I'm asked why. And I say, "Because the market topped out in an area of extreme overvaluation back in 1987. At the '87 highs we experienced every classic indication of a bull market top -- from absurdly low Dow yields (2.58%) to high volume, from frenzied speculation to promises of much higher prices ("Dow 3600"). Even the fact that bonds at the '87 highs were yielding four times what stocks were yielding didn't cool the hyper-optimism. In all, it was what I termed at the time "a textbook bull market top."

The Dow Theory bear signal came on October 15, 1987 followed by the crash of October 19. These two historic events were simply "early warning bells" for Wall Street. Nevertheless, I wrote at the time that we could expect a long, deceptive, difficult bear market. Furthermore, and this is important, I've said that one reason it will be a long, drawn-out bear market is because the government and the Fed will fight the bear with every tool at their disposal.

Believe me, we're seeing that now. Today, with the huge S&L industry in shambles, we see a perfect example of the Fed fighting the bear. Despite what you may hear, it's the money market itself (certainly not the Fed) that has driven the 91-day T-bill yield up to 8.60%. In the face of this, the Fed has held the discount rate down at 6.5%, a full 2% below the bill rate (the low discount rate







allows the banks to borrow money cheaply). Yet the prime rate (the rate the banks charge their best customers) is up at 10.5%. Free reserves in the banking system are over $500 million, a very generous level. Furthermore, the all-important adjusted Fed credit surged during the October to December period at a whopping annualized rate of 12.7%.

Alan Greenspan and the Fed may be talking anti-inflation, but what they've actually done is open the money spigots wide -- which may explain why this bear market has rallied so persistently. The Fed action, by the way, also fuels the fires of speculation and inflation.

PRICE ACTION: Here's a fascinating phenomenon. It's notable that the entire 1974-87 bull market assumed the form of a rising parabolic curve. A parabola occurs when the price action turns up, then accelerates, until finally the price movement asumes an almost vertical angle (and, of course, vertical action cannot be sustained). The accompanying monthly chart (courtesy of *Horsey*) shows the entire 1974-87 bull market plus the crash and the action since.

I have drawn a dashed line outlining the parabolic curve. One characteristic of a parabola is that in its late stages (during the vertical "blow-off" phase) it will usually form a spear-point top -- following which it will often crash as violently as it rose. This is, of course, exactly what occurred in October 1987 .

A second characteristic is that once a parabola tops out, the price action very seldom comes back to equal or better the preceding spear-point high. A completed parabola is a pattern of exhaustion, which explains why, once a parabola collapses, the price action so rarely returns to the old high.

I've included this chart because I believe it shows why those who claim that the crash was "a mistake" -- are themselves mistaken. The crash was almost a predictable resolution to one of the most extraordinary parabolic rises in NYSE history. The recovery from the crash has gone on for nearly 16 months. Cries of "continuing bull market" or "new bull market" are now common on Wall Street and particularly from the brokerage houses. (Lord knows, the brokers need any kind of a bull market -- old or new.)

However, I continue to believe that the verdict is in. I believe the verdict was given back in 1987 and that all the action since is part of a post-crash bear market correction -- with a large portion of wishful thinking thrown in.

I should add that from all appearances the market over the past few weeks has been in a buying-panic phase. The panic has come from the funds and institutions which have been caught with "too much cash in their pockets" in a market that is not only rising -- but spiking up. Thus there is a rush to get rid of cash, to throw greenbacks at the market. Why the concentration on the blue-chips? Because (God forbid) if you're wrong, you'll be sitting with GM or IBM rather than some secondary stock that you may not be able to dump if the market turns down.

TECHNICALS: There's no question about it, almost all indicators have been in sync on the upside. The Dow and the Transports have advanced together into new post-crash high ground. Even the advance-decline ratio, which recorded a post-crash low on November 22, 1988 has advanced steadily, and for the first time it has pushed above a preceding peak (see page 2 chart). Therefore, although in a major or primary sense the A-D ratio has still not confirmed the rise in the Dow, it at least is trending up -- a definite technical plus.

My **PTI** has been pushing steadily into new high territory (full report on the PTI later in this Letter).

DowPow is still locked in its triangle formation, but last week it did better a preceding peak, which is a definite plus.

INVESTMENT POSITION: The bear remains in the box, despite the good market action (bear rallies almost always look good; they have to or no one would believe them). However, the PTI does continue to push higher, and for those who want to speculate against the bear I refer you to the section entitled "High-Yielding Dow Stocks."

With the yield on the Dow at 3.45% and the yield on totally safe 91-day T-bills at 8.60%, the only reason for buying stocks is that they have been going up (you certainly can't buy stocks on the basis of great values). That's worth thinking about.

Despite the new highs in short-term interest rates, bonds continue to hold near their price highs. The bonds, evidently, don't believe inflation is just around the corner. The short-term money market is not so sure. Rates on short-term money is very attractive (some might even call it irresistible).

HIGH-YIELDING DOW STOCKS: I keep stressing values and return on one's investment. In view of that, it is interesting that *Prudential-Bache* has come out with a study showing that investors who bought the 10 top-yielding Dow stocks each year outperformed the Dow by a considerable margin. For instance, from January 1972 to December 1988 the top-10 yielding Dow stocks averaged an increase of 15.6% vs. 10.6% for the Dow as a whole.

In the *Pru-Bache* study the top-10 portfolio was adjusted for the latest top-10 yielders at the end of each year. Equal dollar amounts were placed in each of the latest top-10 yielding Dow stocks. As a rule, this amounted to changes of only three or four Dow stocks each year.

Here's a list of the current 10 highest yielding Dow stocks: Gen Motors 6.0%, Texaco 5.9%, Chevron 5.7%, Allied-Signal 5.5%, Exxon 5.0%, Sears 4.9%, USX 4.8%, Kodak 4.4%, Phillip Morris 4,4%, DuPont 4.3%.

Top-10 investing is an intelligent system, and it indicates that consciously or unconsciously investors tend to opt for the highest return on their dollars -- this preference translates itself into superior relative strength for the high yielders.

Subscribers know that I classify a stock as bullish if (1) it is above its 30-week moving average, and (2) it also has a positive relative strength line. On this basis, the following Dow stocks are now bullish: Aluminum; Amer. Tel.; Beth Steel; Coca Cola; Exxon; GM; Int'l Paper; Merck; Phillip Morris; Texaco; Union Carbide; United Tech.; USX; Woolworth.

GM, Phillip Morris, Texaco, and USX make both the high-yield and the bullish list.

FOR NEW MONEYLINE READERS: Julian Snyder (who has retired for health reasons) has notified all *Moneyline* readers that I will be fullfiling your subscriptions. Therefore, as of this mailing, roughly 7,000 former readers of Julian Snyder's *International Moneyline* will be reading *Dow Theory Letters* for the first time. I want to welcome all of you.

Dow Theory Letters is the oldest advisory in the business (I started these reports back in 1958). Of course, I've hoped my longevity in this difficult field means that I may be doing something right. But to be honest, more than a few subscribers have told me, "Russell, I just like the way you write. You could write about Aardvarks in Asia and I'd read you, so don't start feeling too good about yourself." Which, I'm sure, is excellent advice.

The advisory business is a tough one, and the fact is that that I don't know a single case of a son successfully taking over from his letter-writing father. It's also "a loner's business." People who write market letters are alone -- they think about the markets alone, wrestle with the markets alone, stay awake with the markets alone, and go to sleep with visions of the markets dancing in their lonely brains.

I try to explain all my indicators, all my thinking, everything, within the course of any six-month period. So if some of what I write here sounds foreign to you, sit tight, have patience. Within a few months I believe you'll get the hang of these reports, and that will save you writing long letters to me asking for explanations of this or that.

(Note: Our computers have combed the *Moneyline* list and all duplicate subscriptions were pulled out. But if the electronic brains missed a few, if you are now getting two *Dow Theory Letters*, please notify us.)

I will be in touch with Julian and will include his occasional comments. Julian sent the following a few days ago via FAX: "We are now beginning to enter the true financial danger zone. The crash of October 1987 appears to have vaccinated a vast segment of the investing public as well as many Wall Street professionals against market fear. Reports of the Fed squeeze to fight inflation are getting boring and right now the strong dollar is keeping the Fed from squeezing too hard. People are falling asleep trying to read debt and S&L scare stories. June Wanniski tells us in the *WSJ* that the US doesn't really have to have a recession -- ever, and despite all the investigations the LBO game goes on. All that is needed now to set the stage for a real disaster is the DJI to challenge the old highs. Then, finally, we will have arrived at the classic pre-conditions for a genuine financial crash -- all the bears will be gone. This wasn't the case before the October '87 smash. Too many people saw it coming and unloaded early. Now too many have the gut feeling that nothing is going to happen; the US economy is going to get home free. This is the kind of feeling that makes a man walk off a cliff. Thus, what you have to fear in the stock market now is the lack of fear itself."

Primary Trend Index or PTI (see page 2 chart): I write this report on three distinct and different levels: (1) On a Dow Theory level, or according to long-term investment procedures as dictated under the Dow Theory; (2) on a valuation level, or where the best value-based investments exist at any given time -- regardless of whether those values are in bonds, stocks, gold or anything else, and (3) on a purely technical-mechanical level, which means ignoring ALL extraneous data and information and investing in stocks strictly in line with the trend of my PTI.

What about the PTI? Over the years my PTI has gathered a loyal following. Many subscribers have written to tell me that they read these reports for information, background and interest, but as far as their stock market operations are concerned, they invest strictly with the trend of the PTI.

I compute the PTI daily, and it's an amalgam of eight different market indices and averages, each based strictly on *market action*. I developed the PTI during 1966-1971 and have been publishing the PTI numbers in these reports ever since. The PTI doesn't think, it doesn't figure, and it isn't intelligent. But over the years it's been uncannily accurate -- as my veteran subscribers can attest. The PTI is also absurdly easy to read and follow. As I've said many times before, "To follow the PTI you don't have to be a genius -- all you have to know is up from down."

Where is the PTI today? The PTI has been in a bullish mode ever since mid-January 1988. For the benefit of new subscribers, I should say that the PTI is in the bullish mode any time it is situated above its 89-day moving average. It is bearish anytime it is below its 89-day MA. Why do I use an 89-day MA? Simple, because my computer tells me that this is the best fit. Over a period of many years, the 89-day MA seems to have produced the best results, and most importantly, the fewest whip-saws (over 19 years of actual use, the PTI has produced amazingly few whip-saws).

One of my rules is "never go against the PTI." For PTI traders (based on the current bullish PTI mode) this means (a) you must trade on the bull side of the market as long as the PTI holds above its 89-day MA, (b) you most definitely do not sell short in this market.

One of my observations is that the market will not fall apart unless the PTI traces out a definite downtrending pattern. Conversely, the market will not take off on the upside until the PTI traces out a definite rising-trend pattern.

Many of my long-term value-oriented subscribers invest strictly in accordance with Dow Theory. But all of us have learned to keep a wary eye on the PTI. It's been a winner, and one reason for its success is that it's proprietary. No other service knows how it's constructed, uses it or follows it. Thus, the PTI is not discounted by the stock market (as are so many other widely-watched devices).

Note: Each Friday's PTI figures are listed in the upper right corner of page 1 of these reports. I suggest that subscribers spend a few seconds each week and chart these figures or at least list them. This will give you an excellent feeling for the internal forces that dominate the stock market at any given time.

INDICATORS BASED ON ACTION: I've often said that the art of market analysis lies in knowing what indicators to ignore at any given time. In this business regardless of whether you're bullish or bearish there are a hundred different ways of backing your stance. So where do you look?

Veteran readers know that the market devices I trust most are based on the "action of the market." These are items such as the stock averages, the advance-decline ratio, new highs and lows, DowPow, my PTI -- in other words, anything based on actual price movement. You can manipulate or misinterpret a lot of things in the stock market, but you can't manipulate the daily action of thousands of stocks, and you can't manipulate the daily new highs and you can't manipulate four or five different stock averages or the bond averages.

Against the action studies we have sentiment studies such as insider buying and selling, short-interest studies, odd-lot studies, put/call ratios, percentage of bullish advisors, etc.

We also have the value studies such as yields, price/earnings ratios, book values, etc.

And we have all varieties of monetary studies such as M-1, debit/loan ratio, money velocity, free reserves, etc. On top of that we have the economic studies such as leading indicators, inventory/sale ratios, GNP, etc.

But as I said, what I trust most in dealing with Wall Street is the action of the market itself -- what stocks and stock averages are actually doing. And for long-term perspective I like the value studies with emphasis on stock yields (values are a basic and vital part of Dow Theory).

Many of today's bulls hang their case on the bullishness of continuing "insider buying." But insiders were buying all during 1987 and right into the crash. And I must confess that I'm skeptical of any indicator that fails miserably at a major turn. The fact is that insiders may know everything about their own company, but they don't necessarily know anything about the market. What good does it do to know that your company is doing well in the face of a bear market when price/earnings ratios may be heading for the cellar? So as an indicator of trend during a bear market, I write off insider buying and selling as next to useless.

Another widely-watched indicator is cash held by the funds (often referred to as mutual fund liquidity). The thinking here is that the funds (mistakenly) tend to hold bundles of cash near market bottoms, just when they should be loaded with stocks, not cash. Conversely, funds tend to be low on cash near market tops when they should be loaded with cash and short on stocks. But the funds have had historically high cash levels ever since mid-1986, and they have held those fat cash positions regardless of what the market was doing. So here's another indicator that I pretty much write off.

Then there's the widely-followed put-call ratio. But few investors realize that the SEC changed the rules and now allows specialists to buy and sell options for their own accounts. The specialists are generally astute traders. Since the specialists are now hedging their own accounts with puts and calls, how can the put-call ratio be used as a contrary-opinion device? The answer is it can't.

Conclusion: I'll stick with my value studies plus my action-of-the-market studies. They've worked for as long as I've been in the business. And I think they'll continue to work and be reliable.

NOTES & QUOTES: The verdict on the Russian war in Afghanistan -- a complete Russian defeat. "We had your experience in Vietnam right before our eyes, and we still went in like fools," said an aid to the Communist party's Central Committee (*NY Times*). Adding to that disaster, the Soviet standard of living has actually fallen in the past decade. *Perestroika,* it is feared, may have started too late. More ominous for the West, it is thought that the Soviet conservatives are becoming fed-up. Two weeks ago Andrei Sakharov was quoted as saying, "The conservatives will overthrow Gorbachev or at least impose their views on him." Said his wife, Yelena Bonner, "I think he will be overthrown soon. I would not bet 10 rubles on Gorbachev."

* *

My old friend Bill Tehan of *PR Herzig & Co.* reminds us of what it was like in 1948 when there was little inflation and the nation wasn't leveraged to the hilt. Says Bill, "We regard interest rates as a marketplace expression of the relationship between capital and debt; and therefore, a measure of liquidity. In 1948 the prime rate was 1 3/4%, 90 day T-bills had a yield of 1% and long-term Treasury bonds yielded 2.35%. Honest!"

* *

What's the best investment book on the market? Without hesitation I'd say, "*The Comprehensive Compound Interest Tables*" by Michael Sherman ($5.95 available at Crown Bookstores). Turn to the "Future Value Per Period" section of this book. When you understand the meaning of these tables, you're on your way to wealth.

* *

The biggest cash crop in California is marijuana. In Southern Florida drugs are the major industry. "It's the biggest industry by far," said Steve Schlessinger, prosecutor with the Organized Drug Enforcement Agency. He added, "If drug money were to disappear overnight we'd be a wasteland." An article in the *St. Petersburg Times* stated: "All over Florida people are saying no to drugs and yes to drug money. Most are unaware that they're helping smugglers." Ponder this: The Florida Federal Reserve had a $6.4 billion cash surplus last year, and that was almost half the nationwide surplus total. Where'd all that extra money come from? Guess!

* *

California has 90,000 people in its prisons. It costs this state $19,000 a year to keep a prisoner. It cost $17,500 to go to Harvard or Stanford. Is something crazy somewhere?

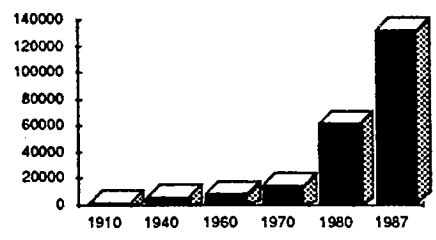
* *

Don't look now, but Social Security benefits and rates have been automatically increased by 4% to reflect changes in the cost-of-living. . . . This year, if you're over 64 years of age, you will be paying a Medicare Catastrophic Health Coverage Surcharge. The rate is $22.50 for each $150 of total tax owed with a ceiling this year of $800 for an individual and $1,600 for a couple. The rates will go up through 1993 at which time an individual will have a ceiling of $1,050 and a couple a ceiling of $2,100. Now get this -- the surcharge is not based on your income, it is based on your income taxes. There are two ways to lower your taxes: Lower your income (which no one wants to do) or lower your taxes. One way to lower your taxes is with municipal bond income. The new surcharge therefore makes muni income increasingly desirable for elderly Americans.

* *

My wife, Faye, is in her second year of law school (University of San Diego), so I'm kind of tuned in to what's happening in this area. By the way, this chart tells you that lawyering is where the women are going. So next time you bump into a car with a woman at the wheel, better act nice, your victim may well be a tough lawyer.

Women Lawyers In United States



Source: U.S. Census Bureau and U. S. Labor Department

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Nobody seems to have noticed, but to me one of the most remarkable football statistics is this: In three Super Bowl appearances, Joe Montana didn't throw a single interception. No wonder the '49ers are winners.

* *

Kenichi Ohmae (from McKenzie's office in Tokyo) continues to write outstanding articles about Japan and the US (this excerpt from a piece in the *Washington Post*):

> TOKYO—Japan is America's number-one student. Unfortunately the lesson that it has been learning in recent years is a bad one: how to grow rich through greed.
>
> As a result, the current Japanese prosperity, which pushed the Tokyo stock market to new highs this month, is, like the current United States prosperity, built upon a rickety foundation. In Japan that foundation is propped up by a superheated real estate market. In the United States the prop is a set of government policies that have made the dollar cheap and interest rates high. These supports could easily collapse with a thud heard from Bangkok to Bangor.
>
> Despite the odds and the economists' predictions, the eight years of the Reagan administration have seen unprecedented economic growth in the free world. That prosperity, however, led by Japan and the United States, has been brought about largely by borrowing from the future. Greed, based on unrealistic expectations of the durability of short-term results, has acquired a momentum far beyond our ability to control it rationally. Government, corporations and individuals in both countries have collateralized their future, and borrowed against it, to generate cash to enjoy *now.*
>
> At the heart of the new Japanese spending psychology is a real estate explosion. Tokyo's land prices have tripled over the last four years, reflecting both the artificially induced scarcity of land available for development in Japan and the superliquidity of the developed world. An owner of real estate has become an instant (but fictitious) millionaire, calculated from the latest sale price from his or her neighborhood. For those lucky enough to own land, savings are no longer needed because of the nominal book value of their individual wealth—against which banks are more than ready to lend. Now more than half of Japanese households, owners of tiny lots, are enjoying *la dolce vita*, thanks to ballooning land values.
>
> By the same token, those Japanese who don't have a house now also have no reason to save because, thanks to the recent price surge, they will never be able to afford one anyway. No matter how hard they try, they will never be able to afford even a 1,000-square foot condominium within an hour-and-a-half commute from Tokyo. At both ends of the wealth spectrum, the Japanese have, all of a sudden, lost the main reason to save and are temporarily gorging themselves on luxury items.
>
> The current economic situation is, in fact, so distorted that Japanese manufacturers can afford to export at a loss, knowing that they can more than make up those losses through financial manipulations. The appreciated assets of stocks and real estates, known here as *fukumi* (hidden assets), can be collateralized or borrowed against with a very small margin. The result is a self-inflating process, hard to curb before it finally collapses under its own momentum.

* *

Uncle Sam is loaded, not only with outstanding loans, but with outstanding loan guarantees. A great deal of this is in the so-called "Off-Budget" area, and this cute little item is finally getting some airing. Here a rundown on the off-the-books items that don't appear on the official budget: Deposit insurance, $2.7 trillion; explicit guarantees, $870 billion; national flood insurance, $169 billion; insurance of foreign investors by US investors, $8.4 billion; crop insurance, $6.9 billion; Pension Benefit Guarantee Corp., $7 billion; misc. debt outstanding and guaranteed such as Fed. Housing Admin., Veteran's Admin., Guaranteed Student Loans, Fed. Ship Financing, Rural Electric and Telephone, Commodity Credit, SBA, etc., $663 billion. Grand total of US Off-Budget commitments . . . $4.4 trillion. This is on top of the federal debt, which by 1990, will be pushing $3 trillion. Russell Comment: Makes you wonder what will happen if a recession hits, doesn't it?

* *

A new Fed ruling has received almost no publicity, but it's unprecedented. The Fed says that as of December 23, 1989, Americans can hold their savings in US banks in any currency they want. Thus, Americans will have a great deal of added flexibility, the same kind that many looked for when they put their money in off-shore banks.

* *

Harry Browne's very worthwhile book has come out in paperback. It's entitled, "*Why the Best-Laid Investment Plans Usually Go Wrong*" (sub–title, "and How You Can Find Safety and Profit in an Uncertain World") -- Simon & Schuster. In the book Browne explains why so many trading systems and techniques don't work and why various investment methods so often lead to losses. Browne goes into the different investment vehicles from bonds to stocks to gold. He then desribes his "permanent portfolio" concept, which is one that deserves study even if you don't follow it. Harry Browne is a true iconoclast, which I might add, is a great advantage in a business which is so often characterized by ignorance and sleaze.

* *

Farm Supports: Over the past 15 years the Agriculture Dept. has underestimated the cost of federal farm support by $47 billion. From 1972 to 1986 farm programs cost $110.7 billion, against government estimates of $63.8 billion during those years. The biggest errors, a total of $15 billion for corn farmers. Russell comment: I wonder when the government is going to offer price supports for investors?

* *

Here's a most interesting chart from *Investor's Daily*. It shows the income tax scale for various developed nations in 1985 and now. The good news is that the US has the lowest top marginal rates. The bad new is that I believe the US will (in time) be tempted to raise the top marginal rate or at least to place a surtax on all income over $100,000 or $150,000.

Personal Income Tax Rates

	1985		Post-Reform		
	Lowest Marginal Rate	Top Marginal Rate	Lowest Marginal Rate	Top Marginal Rate	Effective
Australia	30%	60%	24%	49%	1987
Denmark	50	73	50	68	1987
France	5	65	5	50	1988
Germany	22	56	19	53	1990
Ireland	35	65	35	58	1986
Italy	18	65	11	53	1988
Japan	10.5	70	10	50	1989
New Zealand	20	66	15	48	1986
United Kingdom	30	60	25	40	1989
United States	11	50	15	28	1988

* *

The Japanese stock market (I call it "the yield-less wonder") has again surged into never-never land, with the Nikkei Stock Average now well above 31000. The price/earnings ratio of the average stock in the Nikkei is 70 and the average yield on the Nikkei is below 0.5%. I've always subscribed to the thesis that VALUES ultimately rule the market. If so, Japan (both in its real estate and securities areas) is heading for trouble. In my opinion, it's not a question of whether, it's when. Here's a thought: The Japanese

have no experience or memories of the stock market collapses of 1929, 1937, or 1946, and even 1973-74 didn't rub off on Japan. Thus, they have no experience with catastrophic market reverses, although these experiences do tend to temper US markets.

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Federal debt update: Interest on the national debt totaled $35 billion in the month of December and $68.3 billion for the first three months of the new fiscal year -- up 11.7% from a year earlier.

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As to prices, *Money* magazine put out this interesting comparison of key prices in Tokyo (the world's most expensive city) and Atlanta.

	Tokyo	Atlanta
Steak (one pound)	$83.30	$7.99
Pampers (box of 48)	23.30	11.39
Meal for two at Kentucky Fried Chicken	23.00	14.03
Movie ticket	14.00	4.50
Chicken (one pound, deboned breasts)	7.50	3.99
Pair of pantyhose	6.65	1.49
Taxi fare (two miles)	6.00	3.00

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	Tokyo	Atlanta
Cheerios (10-ounce box)	4.60	1.79
Apples (one pound)	2.50	.88
Milk (one quart)	2.50	.99
Orange juice (one quart)	2.50	1.29
Pack of cigarettes	2.00	1.32
Subway ride (30 minutes)	1.65	.85
Morning paper	1.15	.25

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Early this month, the Bush administration was taken aback when it met with Japan's Prime Minister Takeshita. The Japanese made it very clear that they want a much larger voice in world affairs and that they want to be consulted to a much greater extent when it comes to US policies. The "request" was not without strong backing. Japan holds more than $60 billion of US government securities plus other investments of over $100 billion. Said one State Dept. aide about Japan, "Never in world history has a country acquired so much wealth without acquiring military and political power." The clear implication -- Japan's era of political passivity is rapidly coming to an end.

GOLD, GOLD SHARES, and "BLACK GOLD" (OIL): Last year oil drilling and exploration in the US dropped to the lowest level since record-keeping began back in 1940. At the same time US oil consumption is rising (it was up 3% last year). The US now imports 42% of its oil, and industry experts say this figure will rise to 50% by the early 1990s. What this means is clear enough -- the US is becoming more and more a potential captive of OPEC (OPEC, by the way, controls more than 70% of the world's oil reserves). Until the price of oil rises to $22 or better, it will not be profitable for US oil companies to increase drilling and exploration.

So on the vital energy front the energy-consuming US is increasingly dependent on foreigners to keep our cars going and our homes warm. And on the financial front, the deficit-prone US is increasingly dependent on massive infusions of foreign capital to sustain our "prosperity." To me, the long-term implications of both of these situations are ominous.

In the past gold and oil have, for the most part, moved together (not always but much of the time). Therefore, it is rather fascinating to watch the current wide divergence in the trend of gold and oil. Crude oil, having recently popped over the $20 level, dropped back to near 17, but is currently firming again. If oil consolidates here (rather than breaking below 17) I think we'll see another attack on the 20 level.

Meanwhile, there's a non-confirmation mystery in the gold picture. The metal has been weak, breaking into the low 390s. But strangely, the gold stocks look as if they are under accumulation. Despite the metal's weakness, the XAU gold/silver stock index, which hit a low of 84.81 on December 28, closed up last week, at 95.25. Furthermore, platinum, which I discussed in the last Letter, is still holding above its recent low, thereby refusing to confirm bullion weakness. Finally, according to the *Hadady Market Vane,* the "bullish consensus" for gold is down to 28%. On the *Hadaday* tabulations, there is currently more pessimism on gold than on any of the 31 items they follow with the single exception of orange juice.

Conclusion: Sentiment toward gold and precious metals is now darkly bearish with the price of the metal reflecting that bearishness. But the gold shares are saying something else, and I think they are saying that gold items are now in the accumulation stage. Personally, I continue to buy gold coins on a fixed-dollar monthly basis. With the US and the world debt situation still far from being solved, real money (gold) is something that I want to accumulate regardless of current price.

LATE NOTES: Business is booming, no question about it. December factory orders were up a strong 4% while car sales picked up in late January as did wage demands. All this has created a rising fear of inflation -- a fear being reflected in the short-term money market. On Friday (Feb. 4) the yield on the 91-day T-bill jumped to 8.70%, the highest level in four years (six-month bills went to 9%).

Bolstered by the good business news and the almost irresistibly attractive yields on dollar instruments, the dollar itself strengthened, much to the consternation of Europe and Japan (which have been spending $billions in an attempt to "stabilize" the dollar). A rising dollar means higher prices in the US for imported goods (which is inflationary) and less competitive (higher) prices for US imports In other words, a stronger dollar works against the US trade balance, which again appears to be deteriorating.

From the market (Dow Theory) standpoint, I am watching the D-J Transportation Average. The Transports are now within shooting distance of their 1987 all-time record high of 1101.16. Yet the Industrials are nearly 400 points under their own record high. If the advance continues, and the transports better 1101.16, we will be seeing one of the widest and most dramatic non-confirmations in stock market annals.

Such a non-confirmation, if nothing else, would give us an opportunity to gauge the strength (or weakness) of this advance. Trouble in the stock market is usually preceded (or at least accompanied) by some sort of technical divergence or non-confirmation. So far, the main problem with the post-crash advance has been simply the lagging breadth (for instance, during the entire advance there have been only three days in which there were 1,000 or more advances). (Of course, this is one reason why DowPow has been so weak.)

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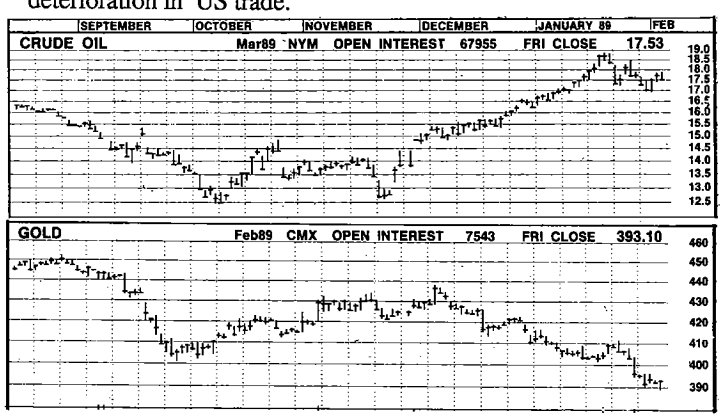
From the *Bank Credit Analysts' "Interest Rate Forecast"* for February: "The bullish case for bonds remains intact. The economy will weaken this year under the impact of tight domestic monetary conditions and a firmer exchange rate. Last vestiges of economic strength pose some short-term risks to the market, but interest rates should end the year far below current levels. The yield on the long-term Treasury bonds is likely to fall to the 7% to 8% range over the next 12 months, producing a total return of 20% to 30%. . . . The present environment is not sustainable. The Fed will have to raise interest rates further in order to contain inflation. This will push the dollar higher and, therefore, force foreign central banks to tighten policy. The vicious cycle will be broken only when the US economy turns down and the catalyst for this will be a deterioration in US trade."



Charts above courtesy of *Investors Daily* newspaper.

NEXT MAILING: Feb. 22